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PROGRAMME OF WORK OF THE INTERGOVERNMENTAL WORKING GROUP OF EXPERTS ON INTERNATIONAL STANDARDS OF ACCOUNTING AND REPORTING: DISCUSSION OF ACCOUNTING ISSUES ARISING DURING PRIVATIZATION, INCLUDING INDIVIDUAL COUNTRY CASE-STUDIES

Accounting problems arising during privatization in the United Kingdom of Great Britain and Northern Ireland

Report of the Secretary-General

SUMMARY

Public industrial enterprises became a substantial part of national output and investment in the United Kingdom following the Second World War. In the 1960s and 1970s there was a significant decline in the economy. By the 1980s, the mood of the Government was for change, and a programme to improve the performance of many of the public industrial enterprises was undertaken. The programme included deregulation by opening the industrial sector to competition from the private sector, and denationalization by floating large share offerings to the public. Because national and international capital markets are highly developed in the United Kingdom, flotation of these shares created no significant problems for the Government. However, because one of

* E/C.10/AC.3/1992/1.

its objectives was widespread ownership, an extensive promotional campaign was undertaken. In order successfully to accomplish the offerings, it was necessary for the Government to provide for substantial restructuring of debt and to assume restructuring costs and pension liabilities to make the privatized enterprises economically viable. Accounting problems were experienced when only part of a state entity was selected for privatization. Allocation of revenues and costs between appropriate accounting periods became a matter for careful analysis. Adequate bookkeeping records frequently were not available. Also, when normal commercial standards were applied to the valuation of assets, adjustments were necessary to change depreciation lives, write-off some past expenditures, and capitalize others.

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I. OBJECTIVES OF PRIVATIZATION

1. The privatization programme of the United Kingdom of Great Britain and Northern Ireland, inaugurated in 1979, rested on two primary and traditional objectives which linked micro-economic and macroeconomic policy: to improve the economic performance of the nationalized industries by placing them under private ownership; and to increase the efficiency of the nation's economic system by restoring market mechanisms and reducing state intervention in economic affairs. Secondary objectives, some of which emerged after privatization activities got under way, were to ease constraints on the State's budget, expand popular support for share-holding, promote participation by the workforce in enterprise capital, and reduce the power of the unions (Santini, 1986, pp. 33-44).

A. Improving enterprise efficiency

2. During the 1960s, the nationalized industries were in a state of decline both economically and financially. This was partly due both to poor domestic conditions generally, as well as a world-wide depression in certain sectors such as the iron and steel industries and shipbuilding. Studies showed that nationally, privately owned enterprises were outperforming their public counterparts. Internationally, the United Kingdom's nationalized industries had poorer results than foreign industries in the same economic sectors (Santini, 1986, p. 34).

3. Other reasons for poor operating performance by the nationalized industries could be attributed to certain government policies. Prices in the nationalized sector had been frozen or controlled in the late 1960s as an anti-inflationary measure. Enterprises had been required to regroup, or undertake to engage in certain acquisitions, for job-conserving purposes, limiting their ability to diversify or otherwise pursue favourable opportunities. Also, procurement policies and commercial relationships were restricted in order to protect the domestic market or to support certain suppliers.

4. By 1975, the number of public corporations had grown to almost 50. They were engaged in very diverse activities, dominating four strategic sectors of the economy: iron and steel, energy, public transportation, and communications. In the aggregate, these industries accounted for 19 per cent of total fixed investment in the United Kingdom, employed 8 per cent of the workforce, and contributed 11 per cent of gross domestic product (National Economic Development Office, 1976b, p. 11). A significant proportion of public-sector performance was, however, attributable to just nine major nationalized industries, as shown in table 1.

Table 1. Role of public corporations in the economy of the United Kingdom, 1975

	Percentages of totals		
	Output	Employment	Fixed investment
Major nationalized industries			
British Airways	0.3	0.2	0.4
British Gas	0.8	0.4	1.7
British Rail	1.2	1.0	1.0
British Steel Corporation	0.8	0.9	2.0
Electricity (England & Wales)	1.5	0.7	2.9
National Coal Board	1.5	1.2	0.9
Post Office	2.8	1.8	4.5
National Bus	0.2	0.3	0.1
National Freight Corporation	0.2	0.2	- a/
Total	9.2	6.7	13.6
Other nationalized industries	0.4	0.2	0.8
Total, nationalized industries	9.6	6.9	14.4
Other public corporations	1.4	1.1	4.6
All public corporations b/	11.0	8.0	19.0

Source: National Economic Development Office, A Study of U.K. Nationalized Industries. Appendix volume (London, Her Majesty's Stationery Office, 1976), p. 11.

a/ Less than 0.05.

b/ Totals may not add, due to rounding.

5. Five of these nine industries - British Gas, British Rail, Electricity, the National Coal Board, and the Post Office - enjoyed an effective monopoly for most of their output. British Steel accounted for about 90 per cent of the crude steel supply in the United Kingdom, but it also competed in the international markets, as did British Airways. Except possibly for the Post Office, some competition did exist domestically by way of imports or alternative goods or services. Expenditures on plant and equipment by six of the nine major nationalized industries referred to above equalled almost one third of all capital goods' purchases by United Kingdom industries. As a result of this massive purchasing power, concentrated in a small range of sectors and involving specialized technologies, various suppliers became captive to the capital investment policies of these relatively few nationalized industries. In certain instances, therefore, market power was both horizontal and vertical (National Economic Development Office, 1976a, p. 14).

6. Following an investigation into capital investment procedures by the Select Committee on Nationalized Industries in 1973, the Government asked the National Economic Development Office (NEDO) to carry out a wide-scale review of the economic role of the nationalized industries and future directions for their control. This study was completed in 1976 (NEDO, 1976a). NEDO's report contained a study by a management consulting firm which reviewed the pricing policies, investment criteria, and financial objectives of four nationalized industries: British Gas Corporation, British Railways Board, British Steel Corporation, and Post Office (Telecommunications). It found a lack of relevance in competitive markets; lack of definition of the standards of service which the industries were expected to deliver; the need to pursue noncommercial service objectives; pricing, or investment policies, which resulted in adverse financial results, and a general limitation on the ability of financial objectives to promote efficiency in a nationalized industry.

B. Improving the Government's financial and operating circumstances

7. Public policy favoured debt financing as the basic financial structure for the nationalized industries right from their inception. At the time of nationalization, the value of the assets vested in the public corporation was accounted for as a loan to be repaid to the Treasury, at prevailing interest rates, in accordance with the time period specified in the legislation. Thereafter, almost all funding took the form of long-term loans from the National Loans Fund administered by the Treasury. The loan periods were determined by the average estimated asset life in each nationalized industry. Industries were also able, with government permission, to borrow on the domestic or overseas capital markets. Because the Government usually guaranteed repayment, such loans were also considered to constitute government borrowings (Likierman, 1979, p. 9).

8. A small number of the industries, such as British Airways, British Steel, and the Post Office Giro, also had financing in the shape of Public Dividend

Capital (PDC), a form of share capital, on which a dividend was payable to the Treasury. The industry's cash limit, referred to above and known as the external financing limit after 1978, was composed of public dividend capital, net borrowings, grants, and leasing. Leasing was included to preclude its misuse by industries as a loophole for violating cash limits.

9. Three main sources of funds were generally available to public corporations to finance their working capital and fixed asset investment needs: internal funding, revenue subsidies and government compensation payments, and borrowings from Government. During the 1960s the relative proportions of total funding attributable to these sources were fairly stable: between 25 and 45 per cent coming from internal funding, 10 per cent from subsidies and compensation, and the remainder from borrowings. A considerable shift in this profile took place in the early 1970s, as detailed in tables 2, 3 and 4.

Table 2. Sources of funds and government revenue support for nine major nationalized industries, 1969-1974 a/ (percentages)

	1969	1970	1971	1972	1973	1974
Internal funding before subsidies/compensation	53	41	41	41	24	17
Government subsidies, compensation etc.	8	6	12	7	39	32
Subtotal	61	47	53	48	63	49
Net increase in borrowings from Government and capital transfers	45	41	51	53	6	24
Net increase in other borrowings	-6	12	-4	-1	31	27
Total sources of funds	100	100	100	100	100	100

Source: National Economic Development Office, A Study of U.K. Nationalized Industries. Appendix volume (London, Her Majesty's Stationery Office, 1976), p. 70.

a/ In the case of six of the nationalized industries, data relate to financial periods ending March in the year following that indicated in the column headings.

Table 3. Capital write-offs and government revenue support for nine major nationalized industries

(Millions of £)

	1963-1968	1969-1974	1963-1974
Revenue subsidies and compensation	853 a/	2 565	3 418
Write-offs of government loan capital against revenue deficits etc.	535 a/	2 194	2 729 a/
Total government financial support of a revenue nature	1 388 a/	4 759	6 147 a/
Internal funding (before subsidies)	3 143	4 043	7 186

Source: National Economic Development Office, A Study of U.K. Nationalized Industries. Appendix volume (London, Her Majesty's Stationery Office, 1976), p. 71.

a/ Excludes £130 million revenue grants and £487 million capital write-offs in 1963 for British Transport Commission, which are properly attributable to the pre-1963 period.

Table 4. Summary of net revenue payments to and receipts from the Exchequer for nine major nationalized industries

(Millions of £)

	1963-1968		1969-1974	
	Interest, tax, dividends to Government	Revenue subsidies and capital write-offs	Interest, tax, dividends to Government	Revenue subsidies and capital write-offs
British Rail & NCB	507	1 256 a/	363	3 046
7 other nationalized industries	1 365	132	3 534	1 713
Total for 9 major nationalized industries	1 872	1 388	3 897	4 759

Source: National Economic Development Office, A Study of U.K. Nationalized Industries. Appendix volume (London, Her Majesty's Stationery Office, 1976), p. 74.

a/ Excludes £130 million revenue grants and £487 million capital write-offs re British Transport Commission.

10. For the nine major nationalized industries in aggregate, the internal funding contributions slipped from a level of 53 per cent in 1969 to about 17 per cent in 1974. Government subsidies and compensation went from 8 per cent to 32 per cent, while borrowings went from 30 per cent to 51 per cent. These statistics were influenced particularly by very poor financial performance from British Rail and the National Coal Board.

11. Subsidies and compensations were not the only form of government revenue support. As detailed in table 3, over £2.7 billion in capital debt was written off for five of the nine major industries. The remaining four - Electricity, British Gas, National Bus, and National Freight Corporation - did not have capital debt write-offs, but the two latter industries had accumulated revenue deficits at the end of 1974 and 1975 (NEDO, 1976b, p. 71).

12. The net revenue burden on the exchequer, detailed in table 4, went from a net £484 million excess of inflows over outflows for the period 1963-1968 to a reverse situation for 1969-1974, when outflows exceeded inflows by £862 million. Here the drain on the public finances by British Rail and the National Coal Board is very evident. At the end of the 1970s, privatization became the political choice for easing the public-sector borrowing requirements.

C. Expanding popular support for shareholding

13. The notion of building up popular capitalism through encouraging share ownership by the general public was an objective which emerged after the privatization movement got underway at the beginning of the 1980s and shares in privatized companies had been offered for sale.

14. The twin aims of increasing fiscal viability in government and decreasing its role in economic affairs were concentrated on activities at the local government level. Privatization's main beginnings were in the highly successful sales of council houses to their tenants, involving over a million transactions by the mid 1980s and the contracting-out of some local services.

15. As the Government began to appreciate the general public's potential as a source of investment funds, the privatization rhetoric shifted its emphasis from the benefits for business efficiency to popular capitalism. John Moore, the minister responsible for privatization, expressed it this way in 1986 (Letwin, 1988, pp. 27-28):

> Our programme, which is already succeeding even beyond the dreams of the optimists, is directed towards the three key areas of life: homes, work-places, and the wider community. We are extending home ownership,

increasing employee participation in the ownership of their companies and spreading the ownership of public companies to millions of ordinary people.

16. The Government went to some considerable lengths to encourage employee share participation, as described below, achieving some notable successes.

II. PRIVATIZATION METHODS USED IN THE UNITED KINGDOM

17. The United Kingdom's privatization programme consisted essentially of three interrelated approaches: deregulation, denationalization, and contracting-out. Deregulation, or opening up activities controlled or dominated by the State to private-sector competition, has, for the most part, been attempted through denationalization - that is, the sale of publicly owned assets, which is the dominant privatization strategy. Contracting-out, or competitive tendering, while on the rise and in some circumstances required by law, has not yet found overall application to any significant extent in the United Kingdom.

18. The various denationalization and deregulation approaches used to date were selected from the viewpoints of both overall policy objectives and the prevailing circumstances. As detailed in tables 5, 6 and 7, public share offerings, yielding the Government over £26 billion in gross proceeds, have been the preferred method of selling state assets, followed by management/employee buyouts and trade sales.

19. Public offerings were a logical first choice for several reasons. Expediting the privatization programme and expanding public ownership of shares were important goals, and large sums of money were involved.

20. The United Kingdom's developed domestic and international capital markets and relative abundance of available capital made it possible for the Government to evaluate the various ways of disposing of national assets. However, ways had to be devised to encourage and assist purchases by small, and probably naive, investors in a country where, in 1981, less than 4 per cent of the population owned shares, as compared with about 19 per cent, for example, in the United States (Santini, 1986, p. 41). These techniques took the form of widespread and comprehensive publicity campaigns and special financing arrangements. Campaigns to advertise share offerings were very extensive, covering most - if not all - the media, and with special coverage for professionals such as accountants and bankers most likely to influence investment decisions.

Table 5. Privatization through public share offerings, 1977-1988

	Sale date	Percentage sold a/	Gross proceeds (millions of £) Company	Government	Total
British Petroleum	June 1977	17.0	-	564	564
	Nov 1979	5.0	-	290	290
	Sept 1983	7.0	-	566	566
	Oct 1987	36.8	1 515	5 502	7 017
		65.8	1 515	6 922	8 437
British Aerospace	Feb 1981	51.6	100	50	150
	May 1985	59.0	188	363	551
		110.6	288	413	701
Cable & Wireless	Oct 1981	50.0	35	189	224
	Dec 1983	22.0	-	275	275
	Dec 1985	31.0	331	602	933
		103.0	366	1 066	1 432
Amersham International	Feb 1982	100.0	6	65	71
Britoil	Nov 1982	51.0	-	549	549
	Aug 1985	48.0	-	449	449
		99.0	-	998	998
Associated British Ports	Feb 1983	51.5	56	(34)	22
	Apr 1984	48.5	-	52	52
		100.0	56	18	74
Enterprise Oil	June 1983	100.0	-	392	392
Jaguar	July 1984	99.0	-	294	294
British Telecom	Nov 1984	50.2	1 290	2 626	3 916
British Gas	Dec 1986	97.0	(2 286)	7 720	5 434
British Airways	Feb 1987	100.0	-	900	900
Rolls-Royce	May 1987	100.0	283	1 080	1 363
BAA	July 1987	100.0	-	1 281	1 281
British Steel	Dec 1988	100.0	-	2 500	2 500
Total			1 518	26 275	27 793

Source: Peter Temple, "Asset stripping by decree?", Accountancy (November 1989), p. 80.

a/ The percentage of shares sold may not total 100, due to rights issued and shares retained for loyalty bonus or employees.

Table 6. Special arrangements for employees of certain privatized industries

	Free shares (per employee)	Matching shares (per employee)	Priority shares		Employees participating (percentage)
			Each	Percentage of total	
Amersham International	35	350	a/	5	99
Associated British Ports, 1983	53	225	a/	3	90
1984	-	-	1 000	-	-
BAA	41	82 b/	4 802	5	n/a
British Aerospace, 1981	33	600	a/	2.5	74
1985	-	-	10 000	2	-
British Airways	76	120 a/	a/	9.5 c/	90
British Gas	52	111 a/	20 000	5 b/	99
British Petroleum, 1979	-	137	137	-	43
1983	-	-	250	-	-
1987	-	-	1 000	-	-
British Telecom	54	77 a/	a/	10 c/	96
Britoil, 1982	28	186	11 500	-	72
1985	-	-	10 000	3	-
Cable & Wireless, 1981	d/	-	a/	5	99
1983	-	-	1 000	-	-
1985	-	-	5 000	1	-
Enterprise Oil	-	-	13 500	-	71
Jaguar	-	-	10 000	7.5	19
Rolls Royce	41	88 b/	5 882	5 c/	..

Source: Howard Hyman, Privatization: the facts. In Privatization and Competition. C. Veljanovski, ed. (London, Institute of Economic Affairs, 1989), p. 205.

a/ No limit.

b/ The Government matched each share purchased with a further 2 shares.

c/ Also 10 per cent discount on up to 1,600 shares (British Airways and British Telecom), 1,481 shares (British Gas) and 1,176 shares (Rolls Royce) per employee if held until final instalment paid.

d/ 285,833 were made available free of charge to the trustees of the Employee Share Schemes.

Table 7. Privatizations through management/employee buy-outs and trade sales, 1979-1989

		Gross proceeds (millions of £ sterling)		
		MBO	Trade sale	MBO/TS
British Shipbuilders				
Warship Yards				
Brook Marine	May 1985	0.1		
Yarrow Shipbuilders	June 1985		34.0	
Vosper Thornycroft	Nov 1985	18.5		
Swan Hunter Shipbuilders	Jan 1986	5.0		
Hall Russel	Mar 1986		..	
Vickers Shipbuilding & Engineering	Mar 1986	60.0		
Scott Lithgow	Mar 1984		12.0	
Govan Shipyard	Aug 1988		..	
Clark Kincaid Ltd.	Dec 1980		..	
Appledore Shipbuilders Ltd.	Jan 1989		..	
British Technology Group (NEB)				
ICL	Dec 1979		37.0	
Fairey	June 1980		15.0	
Ferranti	July 1980		43.0	
Inmos	Aug 1984		95.0	
National Bus Company	Aug 1986-Mar 1988			325.0
National Freight Company	Feb 1982	7.0		
Rover Group				
Unipart	Jan 1987	30.0 a/		
Leyland Bus	Jan 1987	4.0		
British Leyland Trucks	Apr 1987			
DAB	May 1987	7.0		
Istel	June 1987	26.0		
British Rail				
British Rail Hotels	Mar 1983		45.0	
Sealink	July 1984		66.0	
Doncaster Wagon Works	Oct 1987	..		
Horwich Foundry	Aug 1988		2.0	
Travellers Fare	Dec 1988	21.0		
British Rail Engineering Ltd.	Apr 1989			14.0

/...

Table 7 (continued)

		Gross proceeds (millions of £ sterling)		
		MBO	Trade sale	MBO/TS
British Airways				
International Aeradio	Mar 1983		60.0	
British Airways Helicopters	Sept 1986		14.0	
British Gas Wytch Farm	May 1984		80.0 a/	
Royal Ordnance				
Leeds tank factory	Oct 1986		15.0	
Remainder	Apr 1987		190.0	
Rover Group	Aug 1988		b/	
Yorkshire Rider	Oct 1988	23.0		
National Seed Development Organization	Sept 1987		66.0	
General Practice Finance Corporation	Mar 1989		145.0	
Busways	May 1989	14.0		
Short Brothers	June 1989		30.0	
Redpath Doman Long	May 1982		..	
Incomplete total		215.6	949.0	339.0

Source: Peter Temple, "Asset stripping by decree?", Accountancy (November 1989), p. 81.

a/ Initial proceeds only; additional proceeds contingent on future activity for Vickers (£40 million), Unipart, and Wytch Farm (£135 million plus profit share).

b/ Trade sale after cash injection of £547 million.

Note: MBO Management buy-out (including management/employee consortia)
MBO/TS Combination management buy-out and trade sale

21. In 1984, Samuel Brittan addressed the question of public equity rights in state-owned assets turned over to private ownership and suggested free distribution of shares to all adult citizens as well as providing the work force with shares in their own industries (Pliatzky, 1985, p. 47). The first proposal is now under serious consideration in Eastern Europe; the second had already been considered in some of the special arrangements for small investors and employees. The main financial encouragement to the small investor was to provide for instalment payments, usually two or three spaced some months apart. In addition, two inducements to longevity in shareholding were offered in some privatizations: loyalty bonus shares and vouchers. The former represented one free share for every 10 held for at least three years. The voucher scheme, offered by British Gas and British Telecom, allowed customers to take discounts from their billings by those companies after a six-month holding period.

22. In order to meet the goals of providing a wider spread of equity ownership, particularly in the workforce, special consideration was given to the possibilities of using the management/employee buy-out technique. The term "management/employee buy-out" refers to the purchase of a controlling interest in a privatized company by managers and/or employees. The technique is most appropriate when the amounts involved are within the financial capacity of the individuals involved, financing terms can be arranged, and the potential cash flows of the company are estimated to be adequate to meet the debt service requirements. Table 6 shows special incentives that were given to employees of certain United Kingdom enterprises that were privatized.

23. A trade sale is a private sale of government-owned assets to another company or investor. The assets can be sold separately or as a group, so a trade sale is a convenient mechanism to use in the case of downsizing or splitting off. Those fragmented units of the former British Shipbuilders which were not bought out by the management and employees, for example, were disposed of by trade sales. The split-off British Rail hotels were sold to private parties or auctioned off, and Sealink was sold through competitive bidding. Table 7 provides a listing of management buy-outs and trade sales in the period from 1979 through 1989.

III. IMPLEMENTING THE PRIVATIZATION PROCESS

A. The privatization model

24. The planning and control of a privatization model action in the United Kingdom generally follows the three main preparatory stages diagrammed in figure I, even though a variety of possible implementation techniques and strategy options may be available.

25. Common to all of these approaches is the fact that many state-owned activities are public corporations. In order to privatize them by share sales, the predominant technique in the United Kingdom, it is necessary to legislate the creation of a public limited corporation (PLC) to which the assets can be legally transferred. Shares in the new company are held by the relevant Secretary of State and are then transferred by sale to the new owner. As a consequence, there is no general privatization law, since legislation is specific.

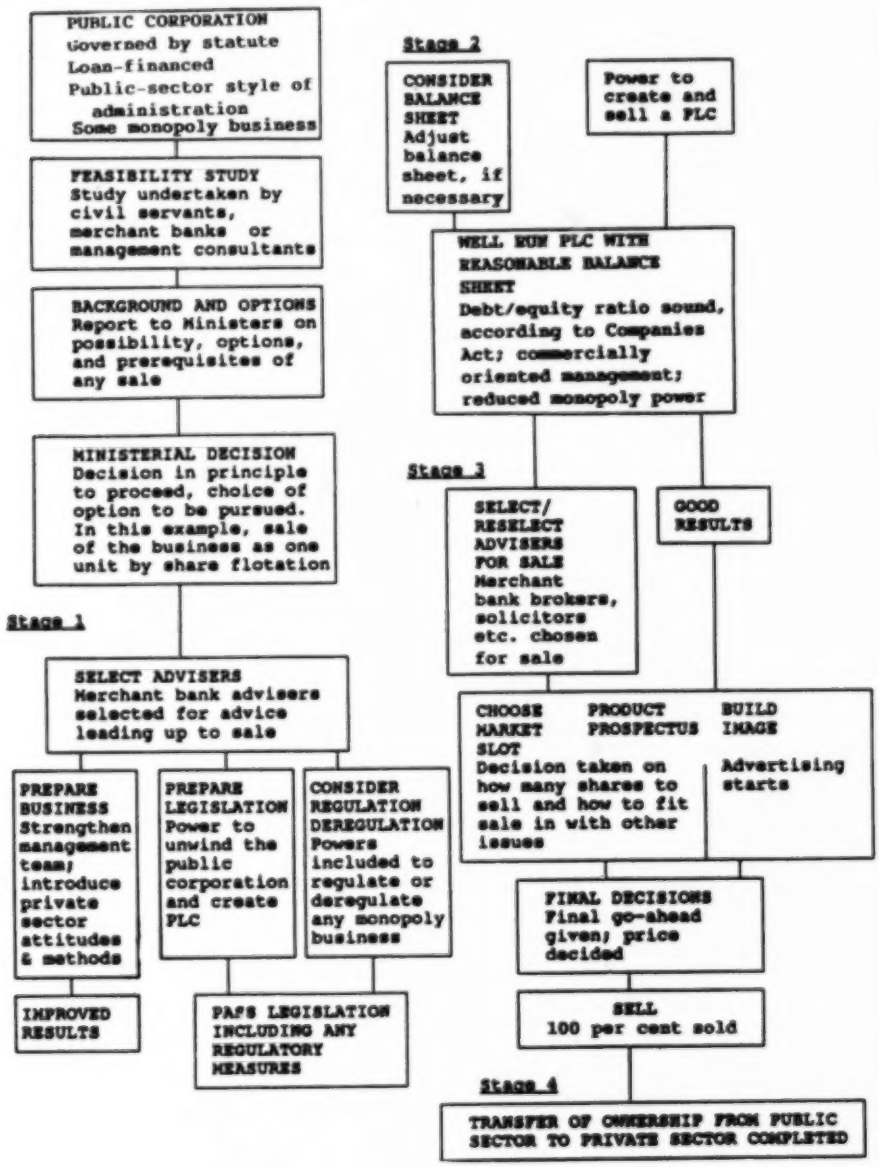
26. Briefly summarized, the general procedure in a share flotation is to commission a feasibility study, followed by a report back to the Minister on the background and options available. The Minister then makes a decision as to how the privatization is to proceed. The activity goes forward in three stages: readying the corporation for the private sector; carrying out any final financial restructuring before getting the state-owned but commercial law company into operation; and putting the company shares on sale.

27. A special feature of certain privatizations in the United Kingdom is the so-called "golden" share (which has been adopted and adapted by other countries). This is a special share created in the enabling legislation to give the government owner certain defined rights, because the company is of strategic importance or the national interest otherwise calls for some degree of government control. In the case of Sealink, which was a trade sale, as described above, the Government invoked the golden share, because a foreign company won in the competitive bidding (Vuylsteke, 1988, p. 165). In this instance, the special provisions enabled the Government to attend and speak, but not vote, at the annual meeting; veto the total liquidation of the company; veto the disposal of an important part of the fleet (25 per cent of the book value) and the right to check that the fleet could be used for purposes of national defence; and restrict one shareholder from owning more than 75 per cent of voting shares (Santini, 1986, p. 59).

28. The processes of privatizing British Telecom (BT), described below, illustrate a public share offering. BT was the first very large corporation sold in this way and some valuation issues arose, as described in section IV. Further, the Government benefited from its experiences with this exercise when floating other companies.

29. BT was established as a public corporation under the British Telecommunications Act of 1981, when it was split off from the Post Office, with exclusive rights to operate public networks and regulate the industry.

Figure I. Typical processes of public corporation privatisation through share flotation in the United Kingdom


PUBLIC CORPORATION
Governed by statute
Loan-financed
Public-sector style of administration
Some monopoly business
FEASIBILITY STUDY
Study undertaken by civil servants, merchant banks or management consultants
BACKGROUND AND OPTIONS
Report to Ministers on possibility, options, and prerequisites of any sale
MINISTERIAL DECISION
Decision in principle to proceed, choice of option to be pursued. In this example, sale of the business as one unit by share flotation
Stage 1
SELECT ADVISERS
Merchant bank advisers selected for advice leading up to sale
PREPARE BUSINESS
Strengthen management team; introduce private sector attitudes & methods
PREPARE LEGISLATION
Power to unwind the public corporation and create PLC
CONSIDER REGULATION DEREGULATION
Powers included to regulate or deregulate any monopoly business
IMPROVED RESULTS
PASS LEGISLATION INCLUDING ANY REGULATORY MEASURES
Stage 2
CONSIDER BALANCE SHEET
Adjust balance sheet, if necessary
Power to create and sell a PLC
WELL RUN PLC WITH REASONABLE BALANCE SHEET
Debt/equity ratio sound, according to Companies Act; commercially oriented management; reduced monopoly power
Stage 3
SELECT/ RESELECT ADVISERS FOR SALE
Merchant bank brokers, solicitors etc. chosen for sale
GOOD RESULTS
CHOOSE MARKET SLOT
Decision taken on how many shares to sell and how to fit sale in with other issues
PRODUCT PROSPECTUS
BUILD IMAGE
Advertising starts
FINAL DECISIONS
Final go-ahead given; price decided
SELL
100 per cent sold
Stage 4
TRANSFER OF OWNERSHIP FROM PUBLIC SECTOR TO PRIVATE SECTOR COMPLETED

Source: Charles Vuylsteke, Techniques of Privatisation of State-Owned Enterprises, vol. 1. Methods and Implementation (Washington, D.C., World Bank, 1988), p. 96.

Note: PLC = public limited corporation.

Formal plans to privatize BT were announced in a July 1982 White Paper by the Department of Trade, entitled "The future of telecommunications in Britain". Essentially, instead of fragmenting BT to promote competition, as it had done in the case of British Shipbuilders, the Government planned to sell slightly more than a majority of BT shares to the public. A new competitive framework was established by the Telecommunications Act of (April) 1984. Among its provisions, BT lost its exclusive privileges, and licensing was required for all telecommunication operators. While the Secretary of State was nominally responsible for granting such licenses, he could delegate this function to the director general of telecommunications, heading the newly created regulatory body, the Office of Telecommunications (OFTEL). The director general's main duties were to monitor market competition and enforce licence conditions. 1/

30. In addition to promoting competition through private ownership, another main objective in privatizing BT was to attempt to double the number of British shareholders by attracting some 2 million first-time investors, about 50 per cent of whom would retain their shares for the long run. This meant that a considerable amount of time, effort, and money would have to be spent on building up the company's image as an investment opportunity and disseminating the publicity widely. Almost one year in advance, at the end of 1983, British Telecom retained a leading public relations company to take charge of its corporate advertising and work together with a second firm responsible for the share offer publicity.

31. A certain amount of organizational restructuring took place in 1984, including the replacement of one half of the members of the Board. Financial restructuring also took place to improve the balance sheet debt to equity ratio, from 60 to 48 per cent, as shown in table 8 (Hyman, 1988, p. 130).

32. This was mainly effected by converting the government debt to unsecured loans and not transferring the long-term liabilities for pensions to the new entity. As a result, the company's equity increased by £1.3 billion.

33. Transfer of the public corporation business to the private company took place in August 1984, and shares went on sale to the public at the end of November. The Government's success in selling some 3 billion shares simultaneously in five countries merits a brief description.

34. Because the Government was attempting to raise a considerable sum of money - between £3 billion and £4 billion - in the largest single share offering attempted to that time, it considered institutional support to be a critical necessity. Consequently, it decided to engage in the underwriting process. Under such an arrangement, an issuing house, or group of houses, known as the lead underwriters, agrees to acquire a certain number of shares at a certain price and under certain conditions. To distribute the risk, brokers acting on behalf of the leaders approach potential long-term shareholders, such as managers of various institutional funds, known as sub-underwriters. If investors do not take up shares offered them by the lead underwriters, the shares are then offered to the sub-underwriters. Three sets

Table 8. British Telecom pro-forma balance sheet showing effect of restructuring (1984)

	Amount (millions of £)	
	Before privatization	After privatization
Government loans	(2 790)	--
Unsecured loans	--	(2 790)
Other net assets	8 740	8 696
Total	5 950	5 990
Ordinary shares	--	1 500
Preference shares	--	750
Long-term liabilities	1 250	--
Reserves	4 700	3 740
Total	5 950	5 990

of commissions are involved: 0.5 per cent to the lead underwriter, 0.25 per cent to the broker, and 1.25 per cent to the sub-underwriter. While this can be a costly procedure for the issuer, it has two perceived advantages: a reputable underwriter provides market confidence, and the proceeds are guaranteed (Grimstone, 1988, p. 110).

35. The main players in the sale of BT shares to the British institutions were a lead underwriter, a lead broker, and three other brokers. A number of institutions were identified as potential sub-underwriters and divided into two groups, one being larger in size than the other. The brokers commenced preliminary meetings with the institutions in January 1984, concentrating at first on the larger group. The contacts continued intermittently until August. In the summer, four brokerage firms issued research reports for institutional investors, with follow-up meetings and tours of BT establishments. Because of the size of the offering, participation by all the major institutions was considered essential, so personal selling campaigns were intensive.

36. In the late spring, a "priority application" plan was put forward whereby sub-underwriters were invited to apply for the entire domestic issue in return for a guaranteed percentage of the available shares, irrespective of the demand by non-institutional investors. The Government finally agreed on a 55-per-cent guarantee which, with hindsight, was very high because of the unexpectedly strong private demand.

37. The main publicity campaign directed towards the general public went into high gear in July 1984, in the press, on the radio and television, and in notices included in customers' bills. More than 2 million people applied for shares, which was 15 per cent over the target. Also over target was the size of the demand: the public was ready to buy four times the total number of shares offered - that is, nearly 13 billion shares were applied for.

38. Other management employee buy-outs proceeded differently. For example, the National Freight Company Ltd., although a large company, with some 30,000 employees, was sold to a management/employee consortium, because its financial condition was not considered sufficiently strong to support a public share offering. The Government wrote off some of the debt and sold the corporation for £53.5 million, of which only £2.5 million in cash had to be paid in. The balance came from a medium-term loan secured by the company's assets. To raise the cash, the consortium issued shares which were 80 per cent subscribed to by the current workforce and pensioners, for an average investment of about £700 per employee. Since that time, the value of the shares has risen about 10 times (Vuylsteke, 1988, p. 31).

39. Following the British Shipbuilders fragmentation, managers and employees invested an average of about £300 in buying out the Vosper Thorneycroft Shipyard and the Vickers and Cammell Laird war shipyards. Preferential treatment given to the employees included interest-free loans for amounts less than £500 and some additional special loans. Furthermore, shares could be purchased for £1 by the employees' consortium, representing an 80 per cent discount from the price charged to professional investors (Vuylsteke, 1988, p. 31).

40. Despite the Government's strong support for privatization, only about 25 per cent of the public sector had been brought under private ownership during the first seven years of the programme. Some interrelated factors were the cause of this delay. Although the Government's policy was to privatize as fast as possible, many of the industries were in poor economic and financial condition. A certain amount of restructuring was necessary to enhance their market appeal. The restructuring was usually both organizational and financial, and in some cases the process of building up the evidence that a candidate would have commercial viability took a good deal of time. The minimum feasible time for privatizing the British Airports Authority, for example, was about 16 months, but some four years elapsed before BAA PLC shares were ready for public sale (Heath, 1988, p. 175).

41. De-nationalizing British Airways also involved a very protracted length of time, and was quite costly. Over £400 million in rationalization costs provisions burdened its operating results for the year ended 31 March 1982, for example. To cut costs, it laid off a large number of employees, closed down unprofitable routes, and replaced some of its fleet with more modern equipment. To attract and retain new business, other outlays had to be made, for such things as advertising campaigns, and improving the quality of service. Top-level management and Board changes were also introduced, with a new Board chairman, chief executive, and chief financial officer in place before the privatization occurred (Hyman, 1988, p. 127).

42. Another major motive for restructuring before privatization has been to promote competition. The restructuring can take several forms, including down-sizing and splitting off. Down-sizing involves the selling off of peripheral assets while maintaining a basic core enterprise. This approach was used in the case of British Shipbuilders, which was fragmented into separate enterprises in order to create a competitive environment out of a monopoly situation. Splitting off, on the other hand, breaks up an enterprise into its main component parts. British Rail, for example, split off certain operations such as the British Rail hotels and Sealink, which were competing with the private sector, so as to expand the opportunities for private ownership.

IV. ACCOUNTING IMPLICATIONS OF PRIVATIZATION 2/

A. Accounting in the nationalized industries

43. The fact that the nationalized industries are organized as public corporations and use accounting and reporting systems which are similar to those of the private sector significantly reduces the number of accounting-related problems potentially involved in the privatization process. The rules governing accounting and reporting by the nationalized industries come from three main sources: legislation and ministerial direction; private sector practice; and self-regulation (Likierman, 1979, p. 5). The legislation covering a particular industry requires that the form of its accounts be approved, or directed, by its Minister, with additional approval by the Treasury. It is a matter of general policy, although not necessarily spelled out in each piece of legislation, that accounts are to be kept in accordance with "best commercial practices". These, in turn, are drawn from the companies acts, the requirements of the stock exchange, professional regulations, and any other appropriate and generally accepted accounting practices.

44. As a result, nationalized industries prepare the three traditional financial statements - balance sheet, profit-and-loss accounts, and a source and application-of-funds statement - plus possibly a statement of retained profits and reserves. Notes to the accounts, including statements of accounting policies and supplementary data, also form part of the accounts. For public corporations, the supplementary information is likely to be,

comparatively, quite voluminous, including various financial and nonfinancial statistical data required by the white papers or otherwise connected with the corporation's role as a mechanism for achieving certain social objectives.

45. Self-regulation of the nationalized companies is carried out through the Nationalized Industries Chairmen's Group. Its 1979 guidelines on inflation acccunting influenced the adoption of current cost accounting by most of the public corporations while the practice was still voluntary for the private sector.

46. The Post Office accounts provide an interesting example of the reporting accommodations required when accounts are prepared on two different bases: historical cost, and current cost. In 1985, Girobank PLC was created out of the property, rights, and liabilities of the Post Office Corporation's Girobank business and incorporated in England as a wholly owned subsidiary of the Post Office. 3/ The following year, Post Office activities were restructured organizationally into three separate businesses: Royal Mail letters, Royal Mail parcels, and Post Office counters, plus central services. For the year ended 1 April 1987, the consolidated accounts for the Group - that is, the Post Office and Girobank and for the separate sets of accounts for the Post Office's three main businesses were presented on the current-cost basis. The Secretary of State's direction to the Post Office with respect to the Girobank business required that its accounts adhere to established formats. Accordingly, the separate accounts for Girobank PLC were presented on the historical-cost basis, together with supplementary current-cost information in the form of a balance sheet, profit-and-loss account, and accounting policies and notes.

47. Supplementary current-cost information is rarely included in the accounts of private companies because of lack of direction as to format by the Accounting Standards Committee (the former standard-setting body, which has been replaced by the Accounting Standards Board). After the privatization of British Telecom, accounts were presented on the historical-cost basis with separate current-cost disclosure for the two prior years. The current-cost disclosure has now, however, been discontinued for the private sector, although it is still required in the public sector (Hyman, 1988, p. 133).

48. Other accounting-related problems which may be encountered in the transition from public to private corporation status include those involving the lack of availability or poor quality of prior transaction data, differences in capitalization and depreciation policies, and the existence or status of liabilities (Hyman, 1988, pp. 132-137).

49. Some public corporations, such as British Telecom and the British Airports Authority, were organized out of former government departments which kept their accounts on the cash basis. Apart from the difficulty of segregating accounting data for activities which are split off, one of the main difficulties with a cash-based accounting system is that, unlike the accrual-based system which the private sector is required to use, it does not provide for matching expenses against revenues in the same accounting period

so as to determine properly operating results. In the case of British Telecom, the auditors had to issue a disclaimer of opinion on the financial results for the years ended on 31 March 1980 and 1981 because of significant uncertainties connected with application of the matching principle. For example, conventional accounting procedures with respect to fixed assets had not been followed. This is because, under a cash-based system, capital asset acquisitions are accounted for as expenditures against budget appropriations rather than as depreciable assets. Also, allocations of revenues between those two fiscal years had to be estimated, because industrial action had interfered with the usual billing procedures. Difficulties in determining both revenues and operating costs, therefore, precluded the auditors from being able to attest to the fairness of presentation of the financial results and to the source and application of funds for those years. It also follows that the poor quality of financial information available for periods prior to privatization makes it difficult for management to present the customary five-year comparative data.

50. Even when public corporations account for fixed assets as capital acquisitions, certain classification changes and revisions of estimated asset lives for depreciation purposes may be called for. In the British Telecom prospectus, for example, the auditors wrote off a significant amount (£196 million) of capitalized costs for telephones and connection installations which should have been expended as nonrecoverable outlays. Estimates of depreciable asset lives may need extending or shortening when a corporation prepares for entry into a new operating environment. Profits for British Gas rose by just under £500 million over a three-year period due to audit adjustments to increase asset lives. Audit adjustments to decrease service lives on British Telecom assets, on the other hand, adversely affected profits by about £130 million for the five-year period covered in its prospectus. However, the auditors also added back amounts ranging between £361 million and £626 million for the period 1980 through 1983 for supplementary depreciation charged by British Telecom for certain fixed-asset replacement costs, since this practice is not in accordance with generally accepted accounting principles in the private sector (Hyman, 1988, p. 134).

51. Of the various liabilities which a public corporation may have partially or completely failed to record in its accounts, one of the most potentially significant may be pension obligations. In the case of the management buy-out of the National Freight Company in 1982, the Government paid £47 million into the pension fund before the sale. British Telecom's liability for a £1,250 million pension underfunding, on the other hand, was removed from the privatized company's balance sheet as a restructuring decision (Hyman, 1988, pp. 135-136). In addition to defining the liabilities and funding, decisions also have to be reached about the future financial arrangements for pension coverage. Three different approaches have been tried in the United Kingdom (Hyman, 1988, p. 136): allowing employees to remain covered by the public-sector plan even though they would be employed in a private company, as in the case of the British Shipbuilder's warship yards; dividing the pension fund between various privatizing entities, as applied to the subsidiaries of the National Bus Company; or, starting a new pension plan for new employees of

the privatized company, while leaving the existing plan available only to those covered by it previously, as in the case of British Airways.

B. Accounting and valuation processes

52. Two main types of problems typically affect the usefulness of accounting information for valuation processes: relevance, and reliability. As discussed above, data gathered in the past for one set of purposes may have little relevance for a reorganized entity which will be operating in a different environment. The reliability of such past data may also be highly suspect for changes in the type of system of accounting, changes in the basic assumptions that underlie accounting estimates and calculations, and the lack of verifiability that it is reasonably free of error and bias.

53. In BT's case

> ... the problems of valuation were particularly acute. The company had no history as a commercial organization; there were no comparable companies in the United Kingdom, and only distant relations in the United States; and the company did not even have very reliable financial accounts. This made the job of those responsible for the flotation and for advising on the issue price very difficult. (Hawkings, 1987, p. 2)

54. The key to unlocking the valuation problem turned out to lie in the expectations of the sub-underwriters. To be an attractive investment to the institutional investors, BT stock had to provide a certain yield; and because the Government placed such importance on their purchasing power, the institutions had a strong hand in the bargaining for an acceptable yield. This led to setting the initial share selling price. It should, perhaps, be clarified that the share price is a residual when the amount of the dividend is set and the dividend yield is agreed upon.

55. Accounting information can be very useful in helping to assess cash flows, internal funding requirements, and the required dividend coverage, all of which are elements entering into the dividend calculation. Based on its unpublished, estimated cash flow projections as of March 1984, the dividend was set at 6.5 pence per share net for the 1985 financial year. By the end of October, just one month before the share issue, the figure had been revised upwards to 7.14 pence and a round number of 1.30 per share arrived at by using a yield rate that it was assumed the institutions would accept. 4/

56. After the initial offering, the considerable excess demand combined with the instalment payment provisions meant that BT shares were soon selling at a premium. This is a very frequent phenomenon with fixed-price offers, as shown in table 9, and the reasons for the premiums on the other issues are similar to those that applied to the BT experience: large numbers of shares coming on to the market, guaranteed percentages of the offering to institutional investors, and the discounting of current market prices when pricing secondary offers (Hyman, 1989, pp. 208-209).

Table 9. Premiums on new issues of shares: fixed price offers

	Offer/ striking price	Price at one week a/	Premium (percentage)
Amersham International	142	192	35
Associated British Ports	112	141	26
BAA (fixed price portion of offer)	245	280	14
British Aerospace	150	178	19
British Airways	125	169	36
British Gas	135	149	11
British Telecom	130	172	33
Britoil (tender)	215	189	(12)
Cable & Wireless	168	198	18
Enterprise Oil (tender)	185	186	--
Jaguar	165	177	7
Rolls Royce	170	288	34

Source: Howard Hyman, "Privatization: the facts", in Privatisation and Competition, C. Veljanovski, ed. (London, Institute of Economic Affairs, 1989), p. 207.

a/ Grossed up for all future instalment payments.

57. Much of the experience in the United Kingdom has shown that accounting data have to be used with caution in the valuation process and may require considerable analysis and restatement. In very difficult valuation cases, competitive bidding and the services of professional valuers have proved effective surrogates.

58. A very valuable feature of public enterprise accounting in the United Kingdom has been, as shown, the use of the corporate form of organization and accounting practices that are compatible with those in the commercial world, to a large extent. To this must be added the background and qualifications of

those responsible for finance and accounting in the nationalized industries. Most, if not all, of the chief financial executives were recruited from the private sector and were thoroughly acquainted with many of the accounting and finance-related aspects of the transition to the commercial environment.

Notes

1/ For a critical assessment of this privatization strategy, refer to Vickers and Yarrow (1986).

2/ This section relies on Hawkings (1987) and Vickers and Yarrow (1986), except as noted.

3/ As of 1 April 1987, Girobank PLC had 18 wholly owned subsidiaries providing leasing, finance, and the undertaking of investments.

4/ For a full account of the BT share price-setting details, refer to Hawkings (1987).

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